

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

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to: Teri L. Jackson
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from: Patrick E. White
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subject: Option Premium Not Treated as Part Interest

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

S	=
P	=
A	=
B	=
C	=

ISSUE

Whether a portion of the deferred premium payments made by S on its purchased options is deductible as interest under § 163 of the Internal Revenue Code?

CONCLUSION

No portion of the deferred premium payments made by S is deductible as interest expense under § 163.

FACTS

S was a member of an affiliated group of corporations whose common parent is P. P and S file U.S. consolidated income tax returns. S, an insurer, wrote variable annuity contracts with minimum guarantee provisions during the years at issue. As part of its strategy of hedging the minimum guarantees, S purchased put options. Those options were subject to the terms of standard ISDA master agreements. The parties memorialized each separate transaction in confirmations.

The master agreements called for interest payments only when a party defaulted on the performance of any payment obligation prior to the termination of the transaction. The confirmations indicated that S was obligated to pay a series of premium payments, generally beginning A months after the effective date and extending over a period of years (often B years); in exchange, S obtained the right to cash settle at maturity of the option for the difference between the then-value of C and a specified strike price.

The confirmations labeled each transaction as a “European Put Option” and characterized S’s obligation to make payments (either monthly or semi-annually) as premium payments. Nothing in the confirmations or agreements indicated that the parties viewed any part of the deferred option premiums as interest payments on indebtedness. Further, the master agreements provided that they constituted the entire agreement and understanding of the parties and superseded all oral communications and prior writings.

In some or all instances, S obtained separate dealer quotes in order to estimate the amount it would have paid if the agreements had required S to make a single premium payment at inception of the options. S used that amount to estimate for Federal income tax purposes a time value charge associated with paying the premium over the life of the options.

LAW AND ANALYSIS

Transactions Were Options -- Not Indebtedness

Taxpayers generally are bound to their characterizations of their transactions. See Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974). The Service, however, is not necessarily so bound and can make adjustments to reflect a transaction’s true substance. Gregory v. Helvering, 293 U.S. 465, 469-70 (1935); Knetsch v. United States, 364 U.S. 361, 366 (1960); Interlochen Co. v. Commissioner, 232 F.2d 873, 877 (1956) (“[T]he Commissioner or the courts may look through the form of a transaction to the substance thereof,” but the choice to disregard its classification of a transaction “does not lie with the taxpayer”).

For Federal income tax purposes, it is well-settled that an option premium is deferred and accounted for as part of gain or loss upon settlement. In Rev. Rul. 58-234, 1958-1 C.B. 279, the Service explained that “[i]t is manifest, from the nature and consequences

of 'put' or 'call' option premiums and obligations, that there is no Federal income tax incidence on account of either the receipt or payment of such option premiums, i.e., from the standpoint of either the optionor or the optionee, unless and until the options have been terminated, by failure to exercise, or otherwise, with resultant gain or loss." See also, Rev. Rul. 78-182, 1978-1 C.B. 265 (the cost of a put is carried in a deferred account as a capital expenditure made in a transaction that is not yet complete.); Rev. Rul. 71-521, 1971-2 C.B. 313 (premium cost "should be carried to a deferred account as a capital expenditure made in an incomplete transaction entered into for profit.") See also, Virginia Iron Coal & Coke Co. v. Commissioner, 37 B.T.A. 195 (1938), *affd*, 99 F.2d 919 (4th Cir. 1938) (installment premium payments were held to only be appropriately accounted for upon lapse of the option).

Section 163(a) permits as a deduction all interest paid or accrued within the taxable year on genuine indebtedness. Indebtedness is an "existing, unconditional, and legally enforceable obligation for the payment of a principal sum." Howlett v. Commissioner, 56 T.C. 951, 960 (1971); see also Gilman v. Commissioner, 53 F.2d 47, 50 (8th Cir. 1931); Old Colony Railroad v. Commissioner, 284 U.S. 552 (1932); Deputy v. DuPont, 308 U.S. 488 (1940). Section 163 requires actual indebtedness; while an indebtedness is necessarily an obligation, not all obligations of a taxpayer are considered indebtedness within the meaning of § 163. Deputy v. Du Pont, 308 U.S. at 497.

The confirmations described S as paying premium, not interest, to the relevant counterparties in return for the cash settlement rights granted. The confirmations and master agreements refer to each arrangement as an option, not as indebtedness. Nothing in the confirmations or master agreements indicated that the parties viewed any part of the premiums as interest payments or considered S's obligation to make premium payments to be indebtedness.

In fact, the parties only contemplated paying interest under the arrangements if one of the parties failed to timely pay amounts due under the contract. Thus, the parties did not consider the premium to be interest, as generally required for such payments to be considered interest under § 163. Midkiff v Commissioner, 96 T.C. 724, 738 (1991), *affd*. sub nom. Noguchi v. Commissioner, 992 F.2d 226 (9th Cir. 1993).

In Koch v. Commissioner, 67 T.C. 71 (1976), *acq.* 1980-2 CB 1, the Tax Court specifically rejected the Service's argument (similar to that made here by S) to treat deferred option premium as interest. In Koch, the Service argued that call option premium received by the taxpayer was interest income that was currently includible where the premium was paid in installments over a number of years and expressed as percentage of the option purchase price. The Tax Court rejected the Service's assertion that the periodic premium payments should be treated as interest income as there was no indebtedness by the optionee to the taxpayer in the ordinary sense of the word. Citing Sterling G. Howlett v Commissioner, 56 T.C. 951, 960 (1971), the Tax Court stated, "[a]n indebtedness has many times been held by us to be an 'existing, unconditional, and legally enforceable obligation for the payment of a principal sum.'"

Koch v. Commissioner, 67 T.C. at 83. See also, Rev. Rul. 63-183, 1963-2 C.B. 285 (Service observed that it is clear that an open-end investment fund's receipt of option premium cannot be considered interest or other § 851 income).

P's characterization of the premium as being part interest is in direct conflict with the parties' written confirmations treating each transaction as a put option and payments by S as premium.

Interest Is Not Imputed Under Relevant Authorities

P cites § 1.446-3(g)(4) of the Income Tax Regulations as support for its treatment of the agreements as containing an embedded loan. P notes that, pursuant to the regulation, a notional principal contract (NPC) containing a significant, nonperiodic payment is treated as two separate transactions consisting of an on-market, level payment NPC and a loan. The provision requires the parties to account for the loan separately from the NPC payments. P reasons that the bifurcation required by this regulation generally supports comparable treatment of its deferred option premium payments.

By its terms, § 1.446-3(g)(4) addresses the tax treatment of NPCs, not options, making it irrelevant. In fact, the more relevant provision, if any, under these rules is § 1.446-3(g)(3). That provision notably provides that the general open transaction rules of taxation for options apply to options to enter into NPCs.

In some limited circumstances, the Code and regulations require the imputation of interest, but those circumstances do not exist here. Congress enacted § 483 to specifically address installment sale transactions where the deferred purchase price effectively was adjusted to compensate for the absence of stated interest. Soloman v. Commissioner, 570 F.2d 28 (1977). More specifically, § 483 requires the imputation of interest on deferred purchase price payments associated with a sale or exchange of property. However, deferred premium option payments are not covered, as § 483 does not apply to any payment under an option to buy or sell property. Treas. Reg. §1.483-1(c)(3)(v); cf. Rev. Rul. 75-563, 1975-2 C.B. 199 (§ 483 applied to a contract that was an option in form only because in substance the arrangement was a sale with deferred purchase price paid).

Based on the above, we do not believe that P properly treated the premium paid as deductible interest expense. P's position is inconsistent with § 163 and the authorities on option treatment. Further, the limited authority on which P relies has no bearing on options.

No opinion is expressed on the application of § 1.446-4 to any income, deduction, gain or loss arising from the option transactions.

Please do not hesitate to contact us if you require further assistance in this matter.